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PROTECTING BUSINESS INCOME:
CONTINGENT BUSINESS INTERRUPTION INSURANCE AND THE EVOLUTION OF TIME ELEMENT COVERAGES

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Executive Summary

First the Tohoku earthquake and tsunami, and then the Thailand floods were wake-up calls to businesses around the world: supply chains are fragile and the consequences of disruptions can be devastating. It does not require massive natural catastrophes to cause critical interruptions to businesses, however – even a minor fire in a mission-critical facility can bring a company to its knees. Companies need to review their risk management strategies for addressing events that can disrupt their businesses and assure that they have appropriate time element insurance coverages in place, including both Business Interruption and Contingent Business Interruption.

Introduction

As many as half of businesses that experience a catastrophic property loss fail. Either they never reopen or they close within a few years of reopening for reasons related to the catastrophic event[1]. In many cases these failures could have been avoided had the company purchased appropriate insurance protection.

Conventional property insurance pays to repair or replace damaged property, but it is not designed to cover the loss of business income while the property is out of commission. Time element coverages, on the other hand, respond to a disruption of business activities by indemnifying the policyholder for lost profits and additional expenses incurred as the result of damage to property.

Too often buyers fail to purchase enough of the right types of coverage, leaving themselves vulnerable to ruinous losses.

Time element insurance coverages have been part of the property insurance portfolio of products for at least a century. What was originally a fairly simple type of business interruption coverage called Use and Occupancy has now been transformed into an array of coverages that continue to evolve to address changing circumstances and needs. While the need for this type of coverage seems self-evident, and though many types of time element coverages have been around for decades, they still are widely misunderstood by many insurance buyers. Too often buyers fail to purchase enough of the right types of coverage, leaving themselves vulnerable to ruinous losses.

Business Interruption (BI) and Extra Expense are the most commonly purchased time element coverages. BI indemnifies a company for lost business income while Extra Expense coverage reimburses a company for additional costs incurred to keep the business operational, in both cases following an insured loss to the policyholder's property. The Tohoku Earthquake in Japan and the floods in Thailand and Australia in 2011 significantly raised awareness of the importance of another time element product, Contingent Business Interruption (CBI) insurance. This coverage provides protection similar to BI, but it responds to insurable losses at key suppliers and other companies essential to the policyholder. Companion coverage, Contingent Extra Expense insurance, protects the company against additional costs incurred to remain operational following damage to a supplier or other significant third party company.

The Fundamentals of Time Element Coverages

Time element coverages are so called because an insured loss is directly related to the interval of time during which the policyholder's business is interrupted following an insured property loss. Typically coverage is based upon the determination of the "actual loss sustained" (as defined in the policy) during the "period of restoration," also sometimes referred to as the "period of interruption"" or the "period of liability."

The most popular forms of time element coverages, BI and Extra Expense, require that the damaged property be owned or under the control of the insured, though that is not a requirement for all time element coverages.

This time interval represents the reasonable time required to repair or replace the damaged property. The most popular forms of time element coverages, BI and Extra Expense, require that the damaged property be owned or under the control of the insured, though that is not a requirement for all time element coverages.

Business Interruption

Direct property insurance will pay to repair or replace damaged property, but without BI coverage, many companies will fail before their facilities are restored. BI assures businesses their net profits for the period of restoration following an insured property loss. Subject to the specific terms and conditions of the policy, the policyholder is entitled to lost revenues or sales net of non-continuing expenses, plus certain additional expenses ("expediting expenses" that help reduce the BI loss).

BI is provided as part of a commercial property policy or a business owner's policy (BOP). For very large companies, BI coverage may be provided under a separate manuscripted policy. Recoveries are subject to a separate BI time deductible – meaning that the period of restoration begins a specified number of hours after the time of direct physical loss or damage at the insured's premises – and may be further subject to so-called coinsurance, which essentially is a penalty for underinsuring.

The concept behind BI is simple enough, but estimating how much coverage is appropriate can be complicated. Since BI covers lost net profits and continuing expenses after a major fire, a natural catastrophe, or another insured event, the goal in setting BI values is to conservatively estimate a company's future revenues and expenses. The process can be relatively straightforward for small, stable companies, but larger or more complex companies, and all companies that are growing or experiencing material changes in structure or strategy, need to consider a wide array of variables to be certain that the calculated BI value is the best estimate of the company's future financial state. Larger companies often use a CPA to provide input into the BI value calculation to be sure all contingencies are addressed.

Extra Expense coverage indemnifies a company for the necessary expenses that it incurs during the period of restoration that it would not have incurred if there had not been direct physical loss or damage to its property.

Extra Expense

If a company can continue to operate at an alternative location while its permanent location is being rebuilt following an insured loss, the impact of the loss event on the company can be significantly reduced. However, it is likely that additional costs will be incurred to procure, set up and operate the alternative location. Extra Expense coverage should be considered for this possibility.

Extra Expense coverage indemnifies a company for the necessary expenses that it incurs during the period of restoration that it would not have incurred if there had not been direct physical loss or damage to its property. It both enables the company to maintain operations when it otherwise might not be able to afford to do so, and allows the business to take steps to expedite the resumption of operations.

Other time element coverages

Protection for time element losses is an evolving area as underwriters respond to new and previously uninsured exposures. Presently there are more than a dozen different types of time element coverages that are widely available. Some of the more common coverages include Civil Authority and Ingress/Egress, both of which respond to situations where access to insured property is prevented because of physical damage elsewhere; Service (Utility) Interruption, which applies to a suspension of operations at insured premises caused by an interruption in utility service to those premises; Rental Value and Rental Income Coverage, which is essentially a form of business interruption coverage for owners of rented property; and Leasehold Interest coverage, which applies to situations where a lease is cancelled as a result of insured damage to the leased property.

The vulnerability of global supply chains has certainly highlighted the need for contingent time element coverages, but it is not only companies with foreign suppliers and customers that need protection.

Contingent Time Element Coverages

BI and Extra Expense coverages require a fire, a windstorm or another covered peril to have caused damage at property owned or controlled by the insured. But what happens if a company's business income is impaired because of damage to a facility of a major customer or supplier?

This certainly is not a new scenario, but it is one that gained a great deal of attention recently following the Tohoku earthquake and ensuing tsunami in Japan and the floods in Thailand and Australia. Businesses are increasingly dependent on the continuity of global supply chains. Last year's natural catastrophes highlighted just how vulnerable global supply chains have become.

Following the earthquake and tsunami in Japan, for example, the delivery of products such as semi-conductors and silicon wafers was delayed. This was not only because of production stoppages, but also because shipping routes and harbors were less accessible. Worldwide, this affected industries such as automotive, computers and electronic devices. In Thailand, floodwaters affected 61 of the country's 77 provinces, shutting down manufacturing facilities with an impact on supply chains around the world.

The vulnerability of global supply chains has certainly highlighted the need for contingent time element coverages, but it is not only companies with foreign suppliers and customers that need protection. Similar issues arose on a large scale among domestic U.S. suppliers and customers following Hurricane Katrina in 2005. And while natural catastrophes can increase the scope and often the complexity of contingent time element losses, it make take no more than a comparatively minor fire at an important supplier to result in costly disruptions to a company's business.

CBI provides income protection against a loss to the property of a third party.

Contingent Business Interruption coverage

While BI reimburses the policyholder for a loss resulting from damage to its own property, CBI provides income protection against a loss to the property of a third party. Depending on the terms of a specific policy, this can include companies that provide goods or services to the insured, purchase the insured's goods or services, or attract customers to the insured. CBI is triggered if:

- There is direct physical loss to a "dependent property;"
- The damage is caused by a covered cause of loss; and
- The loss occurs within the territory specified in the policy.

Like BI, CBI provides coverage for a period of restoration and typically includes a time deductible.

CBI is provided as an extension to a company's property policy. Some insurers use standardized industry-wide forms for smaller businesses, but many insurers have proprietary forms, and large organizations with more complex exposures usually rely on manuscript forms that typically are broader, more comprehensive and tailored to the specific exposures of the insured.

In order to make informed decisions about the scope of CBI coverage required, insurance buyers need to identify key suppliers, customers large enough to damage the company if they suddenly were unable to buy the company's products for a period of time, and other organizations that are critical to the company's success, such as those that attract business to the company (for example, if Graceland were to be shut down by a fire, it would likely be a devastating event for nearby vendors of Elvis memorabilia). This will provide the basis for calculating the amount of CBI coverage that should be purchased. This, however, this can be a challenging exercise, especially for companies with large and complex supply chains.

Like Extra Expense coverage, Contingent Extra Expense coverage reimburses a company for the necessary additional expenses that it incurs during the period of restoration.

If suppliers are concentrated in one region, an event such as a typhoon or a massive earthquake may cripple numerous suppliers, and may delay the delivery of materials from sources not otherwise impaired. Insurance buyers with complex supply chains should work closely with their brokers, procurement department representatives, and representatives of the CFO's office (as well as outside CPAs in some cases) to determine the possible impact on the company of a prolonged disruption to the company's business.

Contingent Extra Expense coverage

Like Extra Expense coverage, Contingent Extra Expense coverage reimburses a company for the necessary additional expenses that it incurs during the period of restoration. However, under Contingent Extra Expense coverage, the damage is sustained by a third party such as a key customer or supplier. Extra expenses typically are defined as those that the named insured would not have incurred had there been no direct physical loss or damage to the premises of a "dependent property," from a covered cause of loss to either avoid or minimize suspension or continue operations, or to minimize the suspension if the named insured cannot continue operations.

Other risk management considerations

CBI and Contingent Extra Expense coverage are critical to many businesses, but they are most effective when incorporated in a broader risk management program incorporating the following processes:

NOTES:

1 Christopher J. Boggs, Business Income Insurance Demystified: The Simplified Guide to Time Element Coverages, quoted in Chip Merlin, "Business Interruption and Extra Expense Insurance are the Most Important Commercial Coverages--and Often the Most Overlooked at Point of Sale and Adjustment," Property Insurance Coverage Law Blog http://www.propertyinsurancecoveragelaw.com/2009/10/articles/insurance/business-interruption-and-extra-expense-insurance-are-the-most-important-commercial-coveragesand-often-the-most-overlooked-at-point-of-sale-and-adjustment/

- Map the company's full supply chain, including both suppliers and transporters(and possibly also brokers or other key middlemen);
- Identify potential failure points;
- Take steps to reduce the severity of or eliminate failure points, including
    - Assure to the extent possible that suppliers adhere to high loss prevention standards and have appropriate insurance protetion,
    - Favor suppliers in stable regions that are less vulnerable to natu ral catastrophes,
    - Diversify sourcing (i.e. having multiple sources of essential sup plies), and
    - Identify alternative sources of supplies and services that can be quickly activated if an existing source is put out of commission.

Conclusion

Time element coverages are important complements to conventional property insurance. Unfortunately, many insurance buyers either are unaware of the coverages or decide they are unnecessary. In some cases agents and brokers are not fully informed on the full spectrum of time element coverages available, and therefore are not able to adequately match their clients' exposures against available products.

At a minimum, almost all businesses should have BI insurance, and many would benefit from Extra Expense insurance. These coverages help assure that companies will survive while their property is being restored following a fire, a windstorm or other event insured under a property insurance policy. A growing number of commercial insurance buyers are coming to appreciate the importance of contingent time element coverages that respond to insurable property losses at key suppliers, customers and other essential organizations. But while insurance coverages are critical, they should be one aspect of a more comprehensive risk management program that seeks to reduce vulnerability to, and increase preparedness for, a catastrophic event.